BAILING OUT WOKENESS OR ADDRESSING SYSTEMIC PROBLEMS IN OUR FINANCIAL SYSTEM?

Recently, the Federal Deposit Insurance Corporation (FDIC) took over two failing banks, causing uncertainty nationwide. However, government involvement in the banking system has long created problems for shareholders and customers in our nation's banking institutions, and especially the American taxpayer.

Congress must ensure bad actor banks are not bailed out, especially those that prioritize achieving wokeness over shareholder profits. Congress must also take steps to reduce moral hazard risks that threaten competition and productivity in U.S. financial intermediation and undermine our nation's long-run economic prosperity.

BACKGROUND

- In March 2023, the FDIC used resolution authority under a "systemic risk exception" to put two U.S. banks—Silicon Valley Bridge Bank, NA (SVBB) and Signature Bridge Bank, N.A. (Signature)—into federal receivership and insure all bank deposits,[1] and the Federal Reserve established an emergency lending facility for eligible U.S. banks to meet any possible liquidity weaknesses.[2]

- Certain red flags were there for regulators to see.[3] Both banks had substantial growth in assets in recent years and a high share of uninsured deposits sensitive to hard-hit sectors over the past year with greater "flight" risk.[4,5]

- SVBB and Signature also had some of the highest proportions of estimated uninsured domestic deposits across the entire industry.[6] SVBB had the highest share overall among banks with more than $50 billion in assets, with 93.8% of its total deposits being uninsured. Signature ranked fourth with 89.3% of uninsured deposits as of year-end 2022.[7]

PRIORITIZING WOKENESS OVER SHAREHOLDERS

- Both SVBB and Signature prioritized Environment, Social, and Governance (ESG) initiatives over prudential corporate risk management and governance.
  - SVBB pledged enormous sums of bank resources to ESG efforts, such as a so-called green "sustainable finance commitment" of $5 billion by 2027 and $11.2 billion toward a 5-year social "community benefits plan."[8] The company made its ESG goals central to its Enterprise Risk Management framework, including $5 billion in Community Reinvestment Act (CRA) loans and investments, $1.3 billion in residential mortgage lending to low- and moderate-income borrowers, achieving 100% carbon-neutral operations by 2025, as well as its use of Diversity, Equity, and Inclusion (DEI) focused criteria for selecting company senior leadership.[9]
  - SVBB was without a Chief Risk Officer for almost 9 months,[10] and no one on its risk committee had any significant risk management experience.[11]

- Signature made climate change and "equitable social impact priorities" central to its business practices.[12] [*For more information on ESG, see RPC's brief "The Danger of Mandating ESG Disclosures"*[13]]

- While shareholders took losses in the FDIC receivership of SVBB, uninsured depositors at SVBB were made whole, and its executives and bank management that benefited over the past several years were bailed out.[14]

- SVBB and Signature had been drawing billions in Federal Home Loan Bank (FHLB) advances as deposits began shrinking over the prior year.[15] At the end of 2022, SVBB had $15 billion in advances from the FHLB of San Francisco to address the liquidity stress from sizeable decreases in deposits that occurred during the final three quarters of 2022;[16] Signature Bank held just over $11 billion in advances from the FHLB of New York.[17]

MORAL HAZARD RISKS AND BANKING SYSTEM INSTABILITY

- Federal deposit insurance was established in the early 1930s when Congress responded to mass bank failures.[18]

- The current limit for FDIC deposit insurance coverage is $250,000 of an account owners' deposits per institution ($500,000 for joint accounts), made permanent in 2010[19] after a temporary measure set at this threshold under the Emergency Economic Stabilization Act of 2008.[20] Prior to 2008, the FDIC deposit insurance limit had been increased in 1980 to $100,000 from $40,000, with coverage expanded to additional non-bank insitutions, including Savings and Loan (S&L) institutions later in the decade.[21,22]

- The moral hazard risks in guaranteed deposit coverage were understood prior to the authorization of federal deposit insurance in the 1930s.[23] Fundamentally, deposit insurance coverage begets more risk-taking[24] that has had a destabilizing impact on our nation's banking system.[25] Banks have a greater incentive to increase their asset risk and leverage, in addition to bank insolvency risk as they compete away deposits from uninsured banks.[26]

- The moral hazard threat in federal deposit insurance has been exacerbated as the implied guarantee, including any that would extend to uninsured deposits,[27] of bailouts of Too-Big-To-Fail financial institutions has increased over the past several decades, dating back at least to the early 1980s with the bailout of Continental Illinois.[28]

- Federal deposit insurance was a contributing factor to the bank insolvencies in the 1980s. [29] Banks, including S&L institutions, failed due to losses stemming from credit risks on loans and liquidity risks resulting from more than a decade of interest rate uncertainty as the Federal Reserve accommodated deficit-spending and consequent inflationary pressures.[30] The federal resolution of the S&L failures cost taxpayers more than $132 billion.[31]

- The moral hazard concerns extend beyond deposit insurance as the government regulates banks in the enforcement of debt contracts and liquidation authority.[32] In both instances, the Federal Government has repeatedly faced enormous political pressure to expand subsidies when policies that induced financial system instability are addressed through bailouts and costly resolutions.[33]

- The banking system induces instability as banks buy government debt and policymakers use the system to redistribute credit to achieve off-budget political goals.[34] Congress has used the nation's banking system to achieve credit transfer policies that it could not, or would not, achieve directly through fiscal policy.

- The off-budget political interference in the banking and financial system is also used to achieve national homeownership goals, such as the enormous influence in the nation's housing market using various government-sponsored enterprises and the Community Reinvestment Act.[35,36] [*For more information on the moral hazard concerns arising from federal guarantees in the mortgage market, see RPC's guide "The Future of Fannie and Freddie"*[37]]

- Federal Reserve policies have remained central to financial instability. Since the 2008 financial crisis, both quantitative easing and tightening have resulted in interest rate uncertainty, impacting financial markets and influencing bank asset holdings.[38,39]

- As seen in Figure 1, banks have increased the share of Treasury and Agency securities (considered safe credit-risk holdings) in their portfolios in recent years. However, they remain exposed to interest rate risk that can devalue these assets (even if unrealized) when interest rates increase. In the event banks need to sell these assets, they can realize losses as the value of these assets fall in a rising interest rate environment.[40]

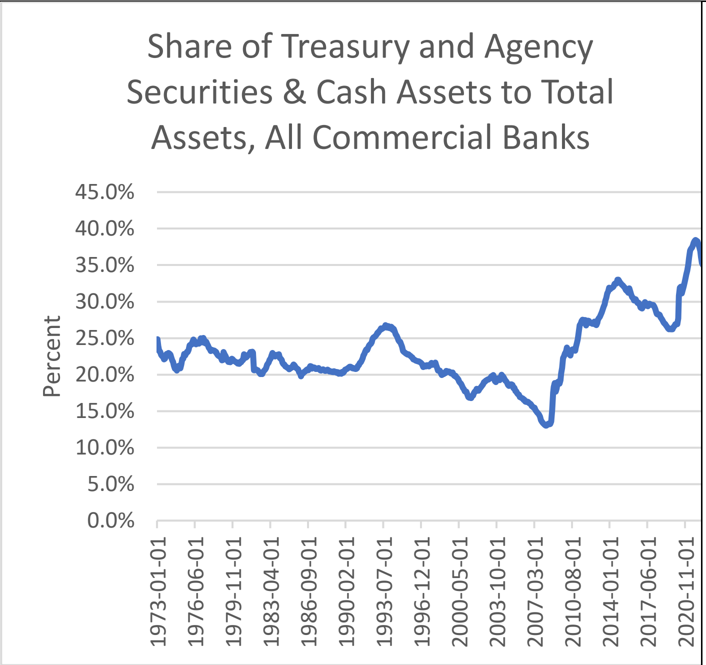

Figure 1[41]

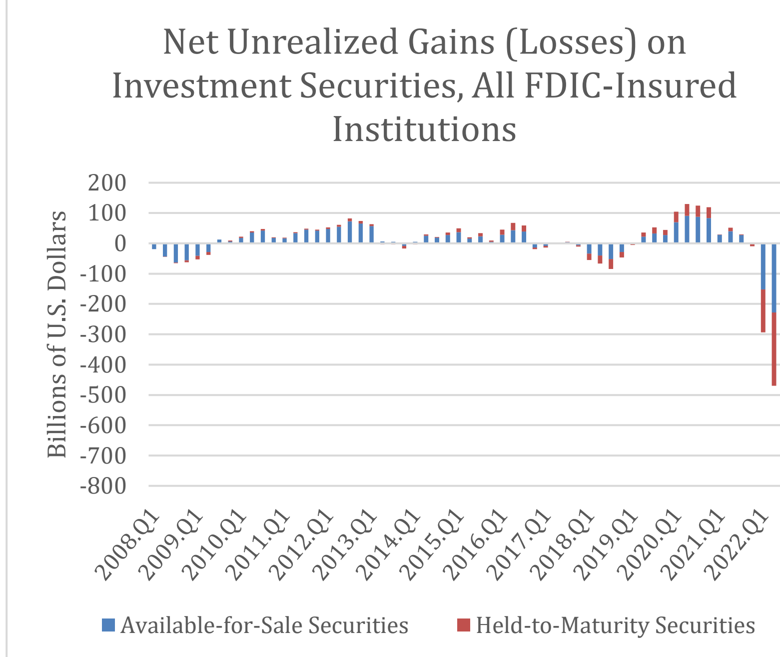

Figure 2[42]

- There are current unrealized losses on investment securities[43] at U.S. banks estimated to total $620.4 billion in the fourth quarter of 2022 (See Figure 2).[44] Even if these embedded bank losses remain only latent risk, the recent government actions taken at SVBB and Signature and threat of additional regulatory oversight could likely impact credit conditions and further dampen the economic outlook.

POLICY SOLUTIONS

- Federal policy should not include any increases to the deposit insurance coverage limits, which would magnify the moral hazard risks in the banking system. Ideally, Congress should repeal provisions established in the Federal Deposit Insurance Reform Act of 2005[45] and the 2010 Dodd-Frank Act[46] that made permanent the limits for deposit insurance coverage, including brokered deposit and retirement accounts, and in doing so, lower the limit to the pre-S&L crisis cap of $40,000. The lower FDIC limit would still far exceed the median household transaction account at $5,300.[47]

- Congress should also establish a cap on the total federal deposit insurance coverage for any one bank of total insured deposits.[48]

- Congress should remove barriers for new entrants into U.S. financial markets and restore conditions for market discipline by removing the moral hazard threat to our nation's financial system that results from expectation of bailout subsidies for failed bank and non-bank financial institutions,[49] including Dodd-Frank Act provisions that designate systemically important financial institutions (SIFIs) and implicit guarantees inherent in Too-Big-to-Fail policies.[50] We must ensure federal regulatory reforms minimize moral hazard risks, restore conditions for prudential market discipline, [51] and encourage robust competition and efficient financial intermediation among our nation's banks, including small- and medium-sized banks.

➢ Congress should remove the Federal Reserve's regulatory and supervisory powers, including those established under the 2010 Dodd-Frank Act, which are unnecessary to its primary accountability to conduct sound monetary policy and duplicative to those of other Federal financial regulators.[52]

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